Did The Markit Group, A Black-Box Company Partially Owned By Goldman Sachs and JP Morgan, Devastate Markets?

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Although much attention has been directed at the contribution made by credit default swaps to the financial crisis, most discussion has focused on the companies, such as American International Group (AIG), that posted big losses because they sold these instruments without sufficient due diligence.

Another line of inquiry has not been pursued, however, though it is of equal, and perhaps greater, significance. That line of inquiry concerns the way in which the prices of credit default swaps effect the perceived value of all forms of debt — corporate bonds, commercial mortgages, home mortgages, and collateralized debt obligations — and as a result, the ability of hedge funds manipulators to use credit default swaps in bear raids on public companies.

If short sellers can manipulate the price of credit default swaps, they can disrupt those companies whose debt is insured by the credit default swaps whose prices are manipulated. The game plan runs as follows: find a company that relies on a layer of debt that is both permanent, and which rolls over frequently (most financial firms fit this description). Short sell that company's stock. Then manipulate the price of the CDS upwards, preferably into a spike, as you spread the news of the skyrocketing CDS price (perhaps with the cooperation of compliant journalists at, say, CNBC).

Because the CDS is, in essence, an insurance policy on the debt of the company, the spiking CDS pricing will cause the company's lenders to panic and cut off access to credit. As this happens, the company's stock will nosedive, thereby cutting off access to equity capital. Thus suddenly deprived of credit and equity, the firm collapses, and the hedge fund collects on its short bets.

Moreover, credit default swap prices are the primary inputs for important indices (such as the CMBX and the ABX) measuring the movement of the overall market for commercial and home mortgages. In the months leading up to the financial crisis of 2008, short sellers pointed to these indices in order to argue that investment banks – most notably Bear Stearns and Lehman Brothers – had overvalued the mortgage debt and property on their books. Meanwhile, several hedge funds made billions in profits betting that those indexes would drop.

It should therefore be a matter of some concern that credit default swap "prices" and the indexes derived from them are determined almost entirely by a little company with zero transparency and, it appears probable, a high exposure to influence from market manipulators. The company is called Markit Group, whose owners include investment banks Goldman Sachs (NYSE:GS) and JP Morgan Chase (NYSE:JPM), and there is every reason to believe that its CDS-driven indices (the CMBX, the ABX, and several others) are inaccurate, while the credit default swap "prices" that they publish and which rock the market are in fact nowhere close to the prices at which credit default swaps actually trade.

Last year, the media reported that New York Attorney General Andrew Cuomo had sent subpoenas to Markit Group as part of an investigation into possible manipulation of credit default swap prices by short sellers. This investigation, like Mr. Cuomo's other investigations into market manipulation, have yielded no prosecutions.

The Department of Justice is reportedly investigating Markit Group for anti-trust violations. This investigation (which is reportedly focused on how Markit Group packages and sells its information) seems to acknowledge that Market Group has near-monopolistic control of information about credit default swap prices. However, if the press reports are correct, the DOJ has not considered the possible appeal of this monopolistic control to market manipulators.

Meanwhile, Henry Hu, the director of the Securities and Exchange Commission's division of risk, has said that it has been nearly impossible for the SEC to conduct investigations into any matter concerning credit default swaps because the commission does not have access to any data on the trading of CDSs. In itself, this is a shocking admission. It is all the more shocking when one considers that the necessary data exists and might be in the hands of The Markit Group – a black box company based in London.

A thorough investigation of Markit Group is urgently required.

Here is what we know so far:

- Markit Group was co-founded by Rony Grushka, Lance Uggla, and Kevin Gould. Prior to founding Markit Group, Mr. Grushka's main line of business was investing in Bulgarian property developments. He recently resigned from the board of Orchid Developments Group, an Israeli-invested company based in Sophia, Bulgaria. Messrs. Uggla and Gould formerly worked for Toronto-Dominion Bank in Canada.
- Markit Group's founders also include four hedge funds. However, Markit Group refuses to disclose the names of those hedge funds. In response to an inquiry, a Markit Group spokesman said it was "corporate policy" to keep the names of the hedge funds secret, but he would not say why Markit Group had such a policy. It seems worth

knowing whether those hedge funds have any influence over Markit Group's published information or indexes, and whether those hedge funds are trading on that information. It would also be worth knowing whether those hedge funds or affiliated hedge funds have engaged in short selling of public companies whose debt and stock prices were profoundly affected by the information that Markit Group published.

- Goldman Sachs (NYSE:GS), JP Morgan Chase (NYSE:JPM) and several other investment banks also have ownership stakes in Markit Group. The investment banks received their stakes in exchange for providing trading data to Markit Group. It would be worth knowing whether these investment banks engaged in short selling ahead of Markit Group's published indexes and price quotations.
- Markit Group is secretive about how it creates its indexes. In early 2008, The Wall Street Journal noted that the CMBX simply "doesn't make sense" and that Markit Group's indexes "might be exaggerating the amount of distress" in the home and commercial mortgage markets. In 2008, the average prediction for defaults on commercial mortgages was 2%. The CMBX implied that the default rate could be four times that level.
- When short seller David Einhorn initiated his famous public attack on Lehman Brothers, one of his central arguments was that the CMBX (the index that was likely "exaggerating the amount of distress") proved that Lehman had overvalued the commercial mortgages on its books.
- In March 2008, the Commercial Mortgage Securities Association sent a letter to Markit Group asking it disclose basic information about how the CMBX index is created and its daily trading volume. "The volatility in the CMBX index, caused by short sellers, distorts the true picture of the value of commercial-mortgage-backed securities," the group said in a statement.
- Markit Group is equally secretive about how it derives its "prices" for credit default swaps. A spokesman for the company spent close to one hour talking to *Deep Capture*. He did his job well and sounded like he was trying to be helpful. But he told us as little as possible.
- However, in the course of this conversation, we did learn that Markit Group's "prices" are not actual, traded prices. They are mere quotations. The Markit Group has what it calls "contributors" – hedge funds and broker-dealers that provide it with information. Markit Group has a grand total of 22 "contributors." *Deep Capture* asked Markit Group's spokesman for the names of these "contributors." The spokesman said he would try to find out the names and call back later. He never called back.
- The 22 "contributors" provide Markit Group with quotations, and these quotations become the Markit Group's "price." In other words, the "contributors" can quote any price for a CDS that they choose, regardless of whether anyone is actually willing to buy the CDS at that price. Markit Group looks at these quotations. Then it somehow decides which quotations make the most sense. Then it publishes information that purports to represent the actual market price of that CDS. This process is certainly unscientific. And it is ripe for abuse.
- Consider, for example, the Markit Group "price" for CDSs insuring the debt of company X. The Markit Group price strongly suggests that company X is going to default on its debt in the immediate future. Short sellers eagerly point to the Markit Group CDS "price" as evidence that company X is doomed. Panic ensues, and suddenly, company X really is doomed. But the fact is, nobody ever bought a company X CDS at the price quoted by Markit Group. Rather, that panic-inducing "price" was, in effect, pulled out of a hat. Who pulled it out of a hat? That is matter of immense importance. There are two possible scenarios:
- The first possible scenario is that the 22 "contributors" report their quotations in good faith. They should be sending the actual traded price, not just a quotation, but assume they are just doing what was asked of them. From these quotations, Markit Group somehow decides what the "price" should be. It is possible that this decision is based on some secret formula (which would be worrisome); or it is possible that Markit Group executives sit around a table debating what the price should be and take a shot in the dark (which would be even more worrisome); or it is possible that Markit Group deliberately chooses the most horrifying price possible in order to assist the short sellers who are affiliated with its owners (which would be a matter for the authorities).
- The second possible scenario is that Markit Group acts in good faith (if not scientifically), but one or more of the 22 "contributors" or their affiliates has an interest in seeing company X fail. If just one of those "contributors" sends in an astronomically high quotation, that could be enough. Markit Group factors the absurd quotation into its posted "price" and it suddenly becomes possible to convince the world that company X is about to default on its debt. Panic ensues, the firm's layer of debt dries up, the stock price plunges, and perhaps the "contributor" or its affiliate make a lot of money.
- As *Deep Capture* understands it, CDS quotations suggested by the 22 "contributors" also help determine the movement of the CMBX and ABX indexes. The movement of these indexes did serious damage to the American economy in multiple ways. The indexes prompted write downs at most of the major banks and mortgage companies. They were ammunition for short sellers, like David Einhorn, who claimed that companies had cooked their books by not writing down to the rock bottom prices suggested by the Markit Group indexes. They helped precipitate the decline in prices of mortgage securities, and contributed mightily to the panic that spread across the markets. A lot of people made a lot of money as result of those indexes moving downward. So, it is rather important to know more about how those indexes are formulated, and if they can be driven by the same people who are making directional bets on their movements.

Conclusion: Ten years ago, there was no such thing as a credit default swap. Six years ago, a very small number of investors traded credit default swaps as hedges against the long-shot possibility of corporate defaults. Nobody looked to credit default swaps as reliable indicators of corporate well-being.

Then, suddenly, there were over $60 trillion in credit default swaps outstanding. That is, over the course of a few years, somebody had made over $60 trillion (many times the gross domestic product) in long shot bets that borrowers would default on their debt. As this derivative risk marbled through the system, the trading in credit default swaps was completely opaque. Nobody knew who bought them, who sold them, or at what price.

But starting in 2001, we knew the "prices" of CDSs. We knew the "prices" because two Canadians, a developer of Bulgarian real estate, and four mysterious hedge funds had founded a small, black-box company in London. That company, the Markit Group, achieved near-monopolistic power to publicize the "prices" through its magic process of aggregating quotation information provided by 22 hedge funds and broker-dealers who could well have been betting on the downstream effects of sudden price changes.

These “prices” were not prices in any meaningful sense of the term. But, suddenly, these “prices” became perhaps the single most important indicator of corporate well-being. Assuming that those four hedge funds and the 22 “contributors” (or hedge funds affiliated with them) bet against public companies, it seems more than possible that short-sellers got to run the craps table, call the dice, and place bets, all at the same time.

So perhaps it is not surprising that a lot of long-shot rolls paid off quite nicely.

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